



**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

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In the Matter of the Application of )  
VALENCIA WATER COMPANY (U-342-W), )  
a Corporation, for an Order Authorizing It to )  
Increase Rates Charged for Water Service in )  
Order to Realize Increased Annual Revenues of )  
\$3,470,000 in a Test Year Beginning July 2007 )  
and \$864,000 in a Test Year Beginning July 2008, )  
and to Make Further Changes and Additions to )  
Its Tariff for Water Service. )  
\_\_\_\_\_ )

Application No. 06-07-002  
(Filed July 3, 2006)

**REPLY COMMENTS OF VALENCIA WATER COMPANY  
ON PROPOSED DECISION OF ALJ BEMESDERFER**

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**REPLY COMMENTS OF VALENCIA WATER COMPANY  
ON PROPOSED DECISION OF ALJ BEMESDERFER**

In accordance with Rule 14.3(d) of the Commission's Rules of Practice and Procedure, Applicant Valencia Water Company ("Valencia" or "VWC") hereby respectfully submits its reply comments on the proposed decision of Administrative Law Judge ("ALJ") Bemesderfer ("Proposed Decision" or "PD"), which was released for comment on May 8, 2007.

**I. SUMMARY OF COMMENTS**

Valencia's reply comments address three aspects of the opening comments of the Division of Ratepayer Advocates ("DRA"):

- DRA's unsubstantiated proposal to eliminate the PD's Conclusion of Law 1, that it is in the public interest for Valencia to construct a demonstration water softening plant;
- DRA's objections to the PD's analysis of the evidence on capital structure issues and to its adoption of Valencia's actual capital structure rather than a fictional ("imputed") one; and
- DRA's various objections to the PD's analysis of the evidence on the return on equity ("ROE") issue and to its adoption of an 11.75% ROE for Valencia.

**II. DRA'S PROPOSAL TO STRIKE THE PROPOSED DECISION'S CONCLUSION  
FAVORING CONSTRUCTION OF A DEMONSTRATION WATER SOFTENING  
PLANT IS COMPLETELY UNSUPPORTED.**

The PD provides a detailed review of the evidence concerning Valencia's Water Quality Improvement Program ("WQIP"), which includes a proposal to construct a demonstration pellet softening plant to determine the feasibility of centralized water softening as a response to customer's concerns about the hardness of Valencia's water supply. PD, at 7-15, 47-48 (Findings of Fact 2-13). The PD finds it in the public interest to approve construction of the demonstration plant, and includes a conclusion of law to that effect. *Id.* at 16, 49 (Conclusion of Law 1).

DRA does not criticize the PD's discussion of the WQIP or the proposed demonstration water softening plant and offers just a few suggestions for clarifying changes to some of the relevant findings. DRA Comments, at 20-21. However, without providing any rationale for doing so, DRA also proposes to strike entirely the PD's conclusion that "construction of a demonstration pellet softening plant is in the public interest." DRA Comments, Att. A, at 2. This DRA proposal is completely unsubstantiated and unjustified, and must be rejected.

### III. DRA'S OBJECTIONS TO THE PROPOSED DECISION'S CAPITAL STRUCTURE ANALYSIS ARE WITHOUT MERIT.

At pages 12-14 of its Comments, DRA throws a few brickbats at the PD's treatment of capital structure, but they are unpersuasive. *First*, DRA denies the PD's characterization of DRA's imputed (*i.e.*, fictitious) capital structure as based on a comparison with large publicly traded water companies. In fact, three of the four companies in DRA's group (California Water, Golden State, and Suburban, are large companies and even the fourth, Park Water, is significantly larger than Valencia. *See*, Exhibit DRA-12 (Aslam), at 3-3. *Second*, just because the cost of Valencia's preferred stock currently exceeds the cost of its long-term debt does not justify pretending the preferred stock obligation does not exist. The only relevant issue is whether Valencia's incurred the cost of the preferred stock imprudently, an issue that DRA never addressed. *Third*, DRA implies a need for evidence to support the PD's recognition that Valencia's rates are moderate relative to comparable companies in the region. That evidence is presented in Exhibit 1 (Johnson/VWC), at 12-4, Table 12-9. *Fourth*, DRA repeats its rejected argument that Valencia's actual capital structure is "burdensome to ratepayers" simply because it results in a higher revenue requirement than a fictitious capital structure imputing a higher share of debt. The evidence supports Valencia's higher-than-average equity ratio and the PD reasonably takes the moderate level of Valencia's rates into account in judging it unnecessary to disallow a fair return by imposing a fictitious capital structure on Valencia. *See*, PD, at 17-20; *see also*, Valencia Opening Brief, at 12-19.

### IV. DRA'S OBJECTIONS TO THE PROPOSED DECISION'S CAPITAL COST ANALYSIS JUSTIFY NO MORE THAN A SLIGHT REDUCTION IN ROE.

The PD provides a detailed summary of the testimony of Valencia witness Zepp and DRA witness Aslam addressing ROE. PD, at 20-26. After noting the major similarities and differences in the analysis provided by the two witnesses, the PD notes that DRA's case for an ROE below that recommended by witness Zepp was "marred by a series of factual and methodological errors," which the PD explains in detail. *Id.* at 26-28. The PD observes that correcting the DRA analysis virtually

eliminates the difference between the two parties' calculated ROE, leaving Valencia's requested ROE of 11.7% "squarely in the middle" of the range indicated by a corrected DRA analysis. *Id.* at 28.

DRA is not happy with this analysis, but its critique of the PD bears little fruit. Valencia will briefly review and evaluate the merits of each of the points DRA raises.

A. It Is Not Improper to Adopt an ROE Exceeding the Utility's Request.

DRA considers it "factual error" that the Proposed Decision adopts an ROE of 11.75% for both test years even though Valencia requested an ROE of just 10.2% for Test Year 2007-2008 and 11.75% for the succeeding year. DRA Comments, at 1-2. The testimony of Valencia witness Zepp justified an 11.75% ROE for both years, but Valencia requested a lower ROE in order to mitigate the overall rate change for the first test year. Even with a higher ROE, the overall revenue increase the PD would authorize is less than the revenue increase Valencia requested for the first test year (\$2,815,795 allowed versus \$3,470,000 requested), so there is no legal impediment to the Commission authorizing an ROE of 11.75% consistent with the evidence in this case. It certainly is not a "factual error" for the Commission to do so.

B. No Error Has Been Shown in the PD's Adoption of a Company-Specific Risk Premium.

DRA sees factual and legal error in the PD's adopting a 90-basis-point company-specific risk premium proposed by witness Zepp, but there is ample evidentiary support for this result and no hint of legal error. The PD bases its adoption of the 90-basis-point premium on Valencia's small size, the greater regulatory risk it faces as a California utility, the continued threat of litigation, and other company-specific risks. *See*, PD, at 48 (Findings of Fact 15-18). Among "other company-specific risks" addressed by Dr. Zepp and noted by the PD are the possibility of catastrophic events affecting Valencia's service area, continuing intervention of "no growth" advocates in proceedings affecting Valencia, and risks that projections of sales growth will be too high and those of legal costs too low due to "constant contention over land development and water supply" in Valencia's service area. PD, at 21-22; *see also*, Exhibit 4 (Zepp/VWC), at 15-29 (detailing specific risks to Valencia that justify a 90-basis-point premium).

DRA contests the company-specific risks noted by the PD, but identifies no error in its evaluation of those risks. DRA Comments, at 2-5. Instead, DRA continues to misstate relevant facts:

- *First*, DRA asserts that the PD "cites no reason" for adopting a small company risk premium, but Finding of Fact 16 belies that claim. Similar "cites no reason" claims in DRA's sections I.B.2 and I.B.3 are belied by Findings 17 and 18.

- *Second*, DRA asserts Valencia cited a DRA/Park Water settlement as precedent for its small company risk premium, but in fact Dr. Zepp cited a Commission finding of fact in an earlier, contested Park Water case, and then noted that the 30-basis-point risk premium in the more recent Park Water case was the recommendation of ***DRA's own cost of capital expert witness***. Exhibit 4 (Zepp/VWC), at 20.
- *Third*, DRA challenges Dr. Zepp's study of the relative cost of equity for small vs. large water utilities on the basis that he improperly treated San Jose Water Company as "small" because it serves "over a million customers." In fact, San Jose Water serves about 220,000 connections, making it much larger than Valencia but still a small company as compared to Cal. Water Service and American States, the two large companies in Dr. Zepp's study. *Id.* at 21.
- *Fourth*, DRA is dead wrong in asserting that Valencia's risks due to catastrophic events, actions of "no growth" groups, and water quality litigation are not company-specific. Dr. Zepp's testimony clearly established that each of these areas of risk is especially serious for Valencia for company-specific reasons. Exhibit 4 (Zepp/VWC), at 23-28. DRA's unsupported denial of these facts gives Valencia no comfort and does not reduce its risk.

C. DRA's Attack on the PD for Accepting Dr. Zepp's Non-Standard Adjustments Is Without Merit, Because Such Adjustments Did Not Change the Recommended ROE.

DRA attacks the PD for accepting Dr. Zepp's "methodological adjustments" to the standard Discounted Cash Flow ("DCF") and Risk Premium ("RP") models and his use of a gas utilities benchmark that contravenes Commission precedent. DRA Comments, at 5-6. DRA fails to recognize that what it calls "methodological adjustments" were corroborative studies, intended to validate and confirm results from applying a standard methodology. Thus, Dr. Zepp updated an RP analysis by DRA and then applied three modified analyses to verify his original results. Likewise, out of concern about the small sample of publicly traded water utilities, Dr. Zepp corroborated his DCF and RP studies of a water utility benchmark group by applying the same tools to a sample of gas utilities. These corroborative studies had no significant effect on Dr. Zepp's results. His standard DCF and RP studies produced a "comparable group" ROE range of 10.6% to 10.9%, to which he added a 90-basis-point company-specific risk premium, showing an 11.5% to 11.8% range reasonable for Valencia. Considering all his corroborative studies, including that of the gas utilities, broadened the range to 11.5% to 12.3%. *See*, Valencia Opening Brief, at 24-26, *citing* Exhibit 4 (Zepp/VWC), at 40-54. The PD's adopted ROE of 11.75% is ***within either range***, and so does not depend on any "methodological adjustments." Attacking the PD on these grounds is without merit.

D. While Correcting the Miscalculations in DRA's ROE Analysis Will Not Equate DRA's ROE Range With Dr. Zepp's, DRA Still Fails to Correct Its Expert's Errors.

DRA denies the PD's assertion, at 28, based on Dr. Zepp's Rebuttal Table 6, that re-running the DRA analysis with corrected data produces a range of required ROE from 11.63% to 12.01%. DRA claims this does not reflect the differences between Valencia's and DRA's analyses and that running DRA's model with corrected data produces a 9.57% ROE. DRA Comments, at 7.

There is some truth in DRA's position. Dr. Zepp's Rebuttal Table 6 (in Exhibit 33) shows the 90-basis-point company-specific risk premium Dr. Zepp believed necessary but DRA rejected, and methodological differences (Dr. Zepp's well-justified exclusion of dividend growth and historical growth) also are reflected in the 11.63% to 12.01% range. However, DRA's claim (Comments, at 7) that DRA's model run with correct data produces a 9.57% ROE is *false*. As Dr. Zepp's rebuttal testimony showed, *accurately* correcting the data in DRA's analysis raises DRA's benchmark ROE to 10.16%. Exhibit 33 (Zepp/VWC), Rebuttal Table 6; *see also*, Valencia Reply Brief, at 18-19.

E. DRA Has Only Itself to Blame for a Decision Setting ROE at a Level Above the Norm.

DRA attacks the PD as out of line with litigated and settled ROE determinations since 2000. Perhaps, in those cases, DRA offered a more credible analysis of ROE-related issues. ***Based on the record presented***, the ALJ set Valencia's ROE at the right level. Any reduction to more closely match recent decisions should (1) recognize that water utility risks have increased in recent years (Exhibit 4 [Zepp/VWC], at 7-10), and (2) note that Valencia is smaller than most utilities on DRA's charts and faces unique company-specific risks warranting a risk premium of 90 basis points. *Id.* at 15-28. Even conceding *all* methodological issues to DRA (which would be wrong), authorized ROE should still be 11.06% (the 10.16% DRA recommendation with corrected data, plus 0.90%).

V. CONCLUSION: DRA's comments do not establish legal error in the PD, but are replete with errors themselves. Accordingly, and for all the reasons stated above, Valencia urges the Commission to give little weight to DRA's comments and to sustain the PD's important conclusions.

Respectfully submitted,

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June 4, 2007

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## **CERTIFICATE OF SERVICE**

I, Jeannie Wong, hereby certify that I will on this date serve by electronic mail or by hand delivery, a copy of the foregoing REPLY COMMENTS OF VALENCIA WATER COMPANY ON PROPOSED DECISION OF ALJ BEMESDERFER on the following parties on the service list for A.06-07-002 listed below:

**By electronic mail:**

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**By hand delivery:**

Hon. Karl Bemederfer  
Administrative Law Judge  
California Public Utilities Commission  
505 Van Ness Avenue, Room 5006  
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Executed this 4<sup>th</sup> day of June, 2007 in San Francisco, California.

/S/ JEANNIE WONG

Jeannie Wong